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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC): REVIEW OF SPAIN, MAY 3

REF: EDR(78)12 AND ADDENDA

1. SUMMARY: SECRETARIAT DRAFT SURVEY OF SPANISH ECONOMY
GIVES CREDIT TO JULY, 1977 STABILIZATION POLICIES AND
MONCLOA PACT FOR BRINGING OFF A DIAMETRIC TURN-AROUND IN
CERTAIN KEY ECONOMIC AREAS (BOP, INFLATION), BUT ALSO
HIGHLIGHTS SOCIAL COSTS IN TERMS OF REAL INCOME AND
UNEMPLOYMENT. OUTLOOK FOR 1978 IS DISMAL IN TERMS OF
DEMAND, PRODUCTION AND EMPLOYMENT, BUT BRIGHT ON CURRENT
ACCOUNT AND PRICES, ACCORDING TO SECRETARIAT. CONCERTED
INTERNATIONAL ACTION TO REVIVE AREA-WIDE GROWTH AND
WORLD TRADE ARE SEEN AS VITAL TO SPANISH RECOVERY,
ALTHOUGH SECRETARIAT FEELS SOME REINFORCEMENT OF DOMES-
TIC DEMAND DESIRABLE. MISSION WOULD APPRECIATE EMBASSY
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MADRID AND WASHINGTON AGENCY COMMENTS ON SECRETARIAT'S
ANALYSIS. MISSION WELCOMES PARTICIPATION OF EMBASSY
MADRID E/C COUNSELOR GOODSPEED AT MAY 3 EDRC EXAMINATION.
END SUMMARY

2. TRENDS TO MID-1977: DOMESTIC SECTOR: ACCORDING TO
SECRETARIAT DRAFT, FOLLOWING THE OIL CRISIS IN 1973-74,

DEMAND AND PRODUCTION IN SPAIN SHOWED A MARKED SLOWDOWN FROM THE STRONG RATES OF GROWTH EXPERIENCED THROUGH THE 60'S AND EARLY 70'S. ALL DEMAND COMPONENTS EXCEPT EXPORTS AND GOVERNMENT SPENDING WERE WEAK. SHARP INCREASES IN WAGES AND NON-WAGE LABOR COSTS, PARTICULARLY SOCIAL SECURITY PAYMENTS, IN CONJUNCTION WITH SHARP RISES IN AGRICULTURAL AND ENERGY PRICES, RESULTED IN A SERIOUS INFLATIONARY SPIRAL REACHING 25 PERCENT CPI INCREASE IN 1977. DESPITE WAGE INCREASES, REAL WAGE INCOME FELL IN 1977. RESPONDING TO THE WEAK PRODUCTION TRENDS, EMPLOYMENT FELL BY SOME 1 PERCENT PER YEAR SINCE 1974 AND UNEMPLOYMENT ROSE TO SOME 832,000 OR 6 PERCENT OF THE LABOR FORCE BY THE END OF 1977 DESPITE SOME LABOR HOARDING DUE TO STRICT DISMISSAL LAWS. NET EMIGRATION TURNED NEGATIVE OVER THE THREE YEARS TO 1977, PARTIALLY BALANCED BY FALLING PARTICIPATION RATES, SEEMINGLY FOR CYCLICAL REASONS. UNEMPLOYMENT IS MOST SERIOUS AMONG FIRST JOB SEEKERS, 60 PERCENT OF THE UNEMPLOYMENT IS MADE UP OF PERSONS UNDER 25 YEARS OF AGE.

3. EXTERNAL SECTOR: WEAK WORLD DEMAND, A DETERIORATION IN THE COMPETITIVE POSITION OF SPANISH EXPORTS AND POLITICAL UNCERTAINTIES COMBINED TO CREATE A BALANCE OF PAYMENTS DEFICIT WHICH BECAME A SERIOUS CONSTRAINT ON ECONOMIC POLICY. ON TRADE ACCOUNT VOLUMES SEEN TO HAVE BEEN SUPPORTIVE OF DOMESTIC PRODUCTION WHEREAS STRONG LIMITED OFFICIAL USE

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NEGATIVE PRICE EFFECTS CREATED A LARGE DEFICIT. SPANISH EXPORTERS HAVE BEHAVED AS PRICE-TAKERS, THUS EXPORT INDUSTRIES HAVE EXPERIENCED A SEVERE PROFIT SQUEEZE, PARTICULARLY GIVEN THE ENTRY OF NEW COMPETITORS IN A SLOW GLOBAL MARKET. IN 1976 AND 1977, THE USUAL LARGE INVISIBLES SURPLUS DECLINED DUE PRINCIPALLY TO UNCERTAINTIES ABOUT THE POLITICAL CLIMATE. THE DEFICIT ON CURRENT ACCOUNT WAS FINANCED BY LARGE LONG-TERM CAPITAL INFLOWS ATTRIBUTED TO STRONG GOVERNMENT AND PRIVATE SECTOR BORROWING. BETWEEN DEVALUATIONS, THE CENTRAL BANK EXPERIENCED SEVERE RESERVE LOSS IN SUPPORTING THE VALUE OF THE PESATA.

4. TRENDS SINCE JULY, 1977 AND THE MONCLOA PACT: THE DEVALUATION OF JULY, 1977, THE ACTIVE STABILIZATION POLICY AND THE SOCIAL AGREEMENTS REACHED AT MONCLOA HAVE RESULTED IN REMARKABLE TURN-AROUND IN KEY ECONOMIC VARIABLES ATTRIBUTABLE AT LEAST IN PART TO CONFIDENCE FACTORS. UNRECORDED CAPITAL OUTFLOWS FROM BEFORE THAT

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PERIOD REFLOWED TO SPAIN; THE INVISIBLE SURPLUS HAS BEEN MORE THAN RESTORED AND THE TRADE ACCOUNT STABILIZED, PRODUCING A REMARKABLE IMPROVEMENT IN THE CURRENT ACCOUNT AND RESTORATION OF ADEQUATE FOREIGN EXCHANGE RESERVES BEYOND EXPECTATIONS. PRICES HAVE ALSO MOVED ONTO A MUCH SLOWER TREND, HELPED MARKEDLY BY FAVORABLE DEVELOPMENTS IN FOOD PRICES. IT IS NOT YET CLEAR WHETHER THE UNDERLYING PRICE TRENDS BASED ON COSTS WILL CORROBORATE THE NEW LOWER PATTERN. ON THE OTHER HAND, DEMAND (ESPECIALLY DOMESTIC) AND PRODUCTION ARE STILL WEAK. SECRETARIAT FEELS THAT THE RISE IN THE INDEX OF INDUSTRIAL PRODUCTION IS MISLEADING GIVEN THE OPPOSITE EVIDENCE INDICATED BY CAPACITY UTILIZATION RATES.

5. ECONOMIC POLICY: THE SECRETARIAT PRESENTS AN EXTENSIVE DESCRIPTION OF THE STABILIZATION POLICIES ADOPTED IN JULY, 1977 AS COMPLETED BY THE MONCLOA PACT AGREEMENTS. IT IS NOT NECESSARY TO GO INTO DETAILS HERE, INSTEAD WE SUMMARIZE THE SECRETARIAT'S COMMENTS:
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-- MONETARY POLICY: ALTHOUGH MONETARY AGGREGATE TARGETS HAVE BEEN REDUCED FOR END-1977 AND 1978, IT APPEARS THAT WEAK CREDIT DEMAND HAS CREATED REASONABLY LOOSE MONETARY CONDITIONS AT PRESENT. THE SECRETARIAT NOTES THAT AGREED REFORMS IN THE FINANCIAL SYSTEM, PARTICULARLY THE REDUCTION OF SUBSIDIZED CREDITS AND THE LIGHTENING OF ADMINISTRATIVE CONTROLS WILL RESULT IN A MORE MARKET ORIENTED ALLOCATION OF CREDIT.

-- FISCAL POLICY: THE SECRETARIAT FINDS THAT THE GOVERNMENT BUDGET HAS BEEN MODERATELY RESTRICTIVE THROUGH 1977 AND DESPITE A SMALL PROJECTED 1978 DEFICIT, FORECASTS CONTINUED MODERATELY RESTRICTIVE FISCAL INFLUENCE. DRAFT SURVEY NOTES THAT SPANISH TAX ARRANGEMENTS, DESPITE THE LOW LEVEL OF AGGREGATE TAX PRESSURE, HAVE EXERTED A DAMPENING EFFECT ON THE ECONOMY DUE BOTH TO THEIR REGRESSIVE NATURE AND TO THEIR INFLATION OF LABOR COSTS. IT NOTES ALSO THAT SHARP INFLATION IN RECENT YEARS HAS RESULTED IN STRONG FISCAL DRAG ON THE ECONOMY.

-- WAGE AND PRICE POLICY: APART FROM DESCRIPTIVE MATERIAL, THE SECRETARIAT NOTES THAT SPANISH ENERGY POLICY HAS CAUSED EXCESSIVE DEMAND FOR IMPORTED PETROLEUM, EXACERBATING THE BALANCE OF PAYMENTS BALANCE.

6. FORECAST FOR 1978: THE SECRETARIAT FORECASTS THAT (A) DEMAND AND PRODUCTION WILL REMAIN WEAK IN 1978, GDP UP LESS THAN 1 PERCENT, (B) PRICE INFLATION SHOULD SLOW DOWN TO A 14 PERCENT RATE OVER THE YEAR, TRANSLATING INTO 18 PERCENT YEAR-ON-YEAR, (C) UNEMPLOYMENT MAY RISE TO OVER 1 MILLION (7 PERCENT OF THE LABOR FORCE) AS EMPLOYMENT FALLS BY ANOTHER 1 PERCENT. LOOKING AT THE LIMITED OFFICIAL USE

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COMPONENTS OF DEMAND, PRIVATE CONSUMPTION (GIVEN THE AGREED RESTRAINT ON WAGES) IS PROJECTED TO REMAIN STAGNANT, GOVERNMENT CONSUMPTION TO RISE 3-1/2 PERCENT (VS. 2 PERCENT IN THE OFFICIAL FORECAST) AND TOTAL PUBLIC AND PRIVATE INVESTMENT TO FALL ANOTHER 4 PERCENT COMPOSED OF ZERO CHANGE IN CONSTRUCTION AND A 9-1/2 PERCENT DROP IN EQUIPMENT. ON THE EXTERNAL ACCOUNT EXPORTS ARE PROJECTED TO RISE 8-1/2 PERCENT IN VOLUME MADE UP OF 6 PERCENT GROWTH IN MARKETS, PLUS A 2 TO 3 PERCENT INCREASE IN MARKET SHARES WHILE IMPORTS (ON THE BASIS OF WEAK DOMESTIC DEMAND) SHOULD RISE ONLY 1 PERCENT, THIS NETTING OUT TO A 1 PERCENT POSITIVE CONTRIBUTION TO DOMESTIC PRODUCTION. THE CURRENT ACCOUNT DEFICIT IS FORECAST TO FALL TO \$1.5 BILLION ASSUMING UNCHANGED TERMS OF TRADE AND A RECORD YEAR FOR TOURISM.

7. SECRETARIAT CONCLUSIONS: ON THE BASIS OF ITS ANALYSIS, THE SECRETARIAT CONCLUDES:

(A) THAT THE JULY, 1977 STABILIZATION POLICY AND THE MONCLOA PACT HAVE HAD A BETTER-THAN-EXPECTED IMPACT ON THE CURRENT ACCOUNT AND ON PRICES, BUT AT A HIGH SOCIAL COST IN TERMS OF UNEMPLOYMENT. INFLATIONARY PRESSURES AND EXPECTATIONS ARE STILL STRONG.

(B) THAT THE SPANISH ECONOMY CAN NOT ENDURE A LONG PERIOD STAGNATION IN PRODUCTION AND DEMAND SINCE IT

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NEEDS A 5 TO 7 PERCENT ANNUAL GROWTH RATE TO REDUCE UNEMPLOYMENT. THE SECRETARIAT NOTES THAT FOREIGN DEMAND IS WEAK AND THAT A CONCERTED RECOVERY IN OECD COUNTRIES WOULD CONSIDERABLY AMELIORATE THE SPANISH PROBLEM. DOMESTICALLY, THE SECRETARIAT SUPPORTS THE GOVERNMENT'S SELECTIVE MEASURES TO PROMOTE EMPLOYMENT WITHOUT FISCAL DETERIORATION, PARTICULARLY MEASURES AIMED AT PROBLEM GROUPS AND AREAS. THE SECRETARIAT ALSO SUGGESTS THAT THE WAGE NORMS AGREED TO IN THE MONCLOA PACT MAY BE EXCESSIVELY TIGHT AND, THEREFORE, A NEW SOCIAL PACT

ALLOWING FOR SOME REAL WAGE INCREASE, BUT AT MINIMAL NOMINAL LEVELS OF INCREASE, IS NEEDED SO THAT DOMESTIC DEMAND CAN BE MODERATELY STIMULATED. IN THIS CONTEXT, HOWEVER, THE SECRETARIAT STATES THAT STABILIZATION POLICY MUST REMAIN PREEMINENT.

(C) THAT FASTER GROWTH WOULD BE EXTREMELY USEFUL IN EASING THE PRESSURE TO FREEZE EMPLOYMENT INTO CURRENT INDUSTRIAL PATTERNS AND THUS WOULD HELP SHIFT RESOURCES LIMITED OFFICIAL USE

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TO MORE PRODUCTIVE AND COMPETITIVE SECTORS.

(D) THAT THE TAX STRUCTURE AND PARTICULARLY NON-WAGE LABOR COSTS MUST BE ADJUSTED TO REDUCE THE ARTIFICIALLY ELEVATED COST OF LABOR. THE SECRETARIAT WELCOMES RECENT GOVERNMENT PROPOSAL IN THIS AREA.

(E) THAT A MEDIUM-TERM ENERGY POLICY IS URGENTLY REQUIRED BOTH ON RESOURCE ALLOCATION AND BALANCE OF PAYMENTS GROUNDS.

7. MISSION COMMENTS:

(A) SECRETARIAT CAREFULLY PHRASES A RECOMMENDATION THAT A MODIFIED SOCIAL PACT ON NOMINAL WAGES AND PRICES COULD PERMIT THE RELAXATION OF DEMAND MANAGEMENT IN SPAIN BY THE END OF 1978. THE SECRETARIAT ARGUES THAT SINCE SPAIN CAN NOT EASILY ACCEPT DEMAND STAGNATION AND SINCE WORLD TRADE SEEMS UNLIKELY TO STAGE A STRONG RECOVERY, SOME MEANS MUST BE FOUND TO STIMULATE DEMAND AND PRODUCTION BY DOMESTIC MEASURES. GIVEN THE INFLATION RISK, WHICH THE SECRETARIAT DOES RECOGNIZE, IT SEEMS TO US THAT ANY SUGGESTION TO RELAX DEMAND MANAGEMENT OR INCREASE REAL WAGE RISES MUST BE VERY CAREFULLY PHRASED SO AS TO AVOID INCREASING PRESSURE FOR EXCESSIVE INCREASES OF LABOR COSTS.

(B) RECENT DEVELOPMENTS IN SPAIN SEEM TO INDICATE THAT THE SOCIAL COSTS OF THE RESTRICTIVE POLICY AGREED TO IN THE MONCLOA PACT ARE BEGINNING TO CAUSE SECOND THOUGHTS. MISSION PLANS TO ASK SPANISH DELEGATION WHETHER IT HAS BEEN POSSIBLE TO FIND WAYS TO ALLEVIATE THE SOCIAL COSTS WHILE PURSUING THE STABILIZATION PROGRAM.

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(C) THE SECRETARIAT MAKES A GOOD CASE THAT THE TAX STRUCTURE AND SOCIAL SECURITY CONTRIBUTIONS HAVE SHARPLY INCREASED THE COST OF LABOR AND MAY BE A PRIME CAUSE OF CURRENT UNEMPLOYMENT, PARTICULARLY AMONG THE YOUNG. MISSION WOULD, THEREFORE, SUPPORT SECRETARIAT RECOMMENDATION FOR TAX REFORM TO SHIFT SOME OF THE REVENUE CREATION FROM LABOR COSTS.

(D) MISSION PLANS TO ASK SPANISH DELEGATION WHETHER THE ENTIRE STRUCTURE OF INTEREST RATES WILL BE ABLE TO ADJUST IN SUCH A WAY THAT THE MARKET CAN EFFICIENTLY ALLOCATE RESOURCES. IT IS EVIDENT THAT SOME INTEREST RATES ARE NOW NEGATIVE THUS FOSTERING EXCESS DEMAND AND INEFFICIENT ALLOCATION.
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